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1-1-1988

In our opinion... , vol. 4 no. 4, October, 1988

American Institute of Certified Public Accountants. Auditing Standards Division

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Recommended Citation

American Institute of Certified Public Accountants. Auditing Standards Division, "In our opinion... , vol. 4 no. 4, October, 1988" (1988). *Newsletters*. 1292.

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In Our Opinion...

*The Newsletter of the AICPA Auditing Standards Division**

Volume 4 Number 4

October 1988

IN THIS ISSUE...

• THE NEW FRONTIER OF AUDITING	1
• REPORTS ON OCBOA PRESENTATIONS: WHAT THEY ARE AND WHAT THEY AREN'T	2
• TECHNICAL PLAN HIGHLIGHTS	3
• RECENT DIVISION PUBLICATIONS	4

THE NEW FRONTIER OF AUDITING

by Raymond Johnson

The AICPA's Statement on Standards for Attestation Engagements (SSAE), *Attestation Standards*, provides three ways—examination, review and agreed-upon procedures—for CPAs to express assurance about assertions other than financial statements. Since this standard appeared in March 1986, CPAs have accepted a variety of new attest engagements which have raised questions about how to apply the standards.

Recently, the AICPA Auditing Standards Division convened a group of leading practitioners to identify these questions. This article summarizes the results of the group's discussions of

- The differences between attest engagements and MAS engagements.
- Reasonable criteria to support assertions.
- Use of attest reports.
- Reporting on financial statements that follow neither generally accepted accounting principles nor another comprehensive basis of accounting.

MAS OR ATTEST ENGAGEMENT?

A CPA should ask whether the purpose of the engagement is to advise the client about a particular need or to attest to the reliability of an assertion. As the following case shows, the CPA's answer determines whether the engagement is an MAS engagement or an attest engagement.

A client company asks a CPA to determine the value of shares owned by a shareholder who's withdrawing from the company's management. Previously, the client had engaged another CPA to perform a similar valuation and this work is available to the second CPA.

Is this an MAS engagement—advising the client's management on the valuation of the company—or is it an attestation engagement—reporting on the reliability of the other CPA's valuation?

The MAS Answer. The engagement could easily be structured as an MAS engagement. If the resulting report directly addresses the valuation of the withdrawing individual's shares without reference to the reliability of the other CPA's calculations, it's an MAS engagement. The second CPA may use the first CPA's report as part of the basis for his or her conclusion. The MAS report could even be distributed to an outside shareholder by the client.

The Attest Answer. If the second CPA is asked to provide an in-depth commentary on a valuation calculation prepared by the first CPA or address the reliability of this valuation, the engagement is

an attest engagement. This holds true even if the distribution of the report is restricted to management.

An attest engagement can also occur even if the second CPA addresses the work of the first CPA without explicitly expressing a conclusion about the first valuation. For example, if the CPA issues a report that includes an enumeration of procedures that could reasonably be expected to provide assurance about the work of the first CPA, the second CPA's work may be construed as an attest report even though it omits an explicit conclusion on the reliability of the valuation.

Additional guidance on this issue can be found in the AICPA's special report, *Comparing Attest and Management Advisory Services: A Guide for the Practitioner*.

WHAT ARE REASONABLE CRITERIA?

The third general attestation standard allows CPAs to do attest services only if they believe the client's assertion can be measured consistently against reasonable criteria.

For example, a software developer—manufacturer has come up with a new financial planning software package. The company prepares an extensive description of the features and capabilities of the program for use by prospective purchasers. The company then asks the CPA to provide examination level assurance—an opinion—on whether the software package is suitably designed to

- Achieve the financial planning objectives specified in the description.
- Perform mathematical computations accurately and consistently.
- Estimate liabilities for federal income taxes in conformity with the Internal Revenue Code.

In addition, the CPA is asked to determine whether the package is an effective financial planning program.

The company plans to include the product description in promotional material containing a statement that the company's description has been "examined" by its independent CPA and that a copy of that CPA's report is available on request.

OK to Attest. The first three criteria can most likely be evaluated consistently. The CPA should be able to determine if the software design accomplishes specific objectives and if it performs mathematical computations accurately. While extensive testing may be required to ensure that the relevant aspects of the federal income tax regulations are considered, such regulations do represent reasonable criteria.

No Attestation. The fourth criterion, however—that the software is an effective financial planning program—is very subjective. “Effective financial planning” isn’t a precise concept and different CPAs will likely have different views of what this assertion means. Hence, this criterion can’t be measured consistently, and the CPA is precluded from attesting to the assertion.

A Note on Independence. Do the company’s plans to use the attestation report to promote its software impair the CPA’s independence? The fourth general attestation standard tells CPAs that they must be independent in fact and must avoid situations that impair the appearance of independence. In the above case, however, the CPA’s independence isn’t impaired. The client’s planned use of the attestation report is no different from a common situation: A client uses audited financial statements to promote its efforts to raise debt or equity capital.

IS IT OK TO REFER TO A REPORT?

In the above example, the company intends to state that the software description has been examined by its independent CPA and that a copy of the CPA’s report is available on request. Is it appropriate only to refer to the CPA’s report rather than print it? The answer depends on the type of report the CPA issues.

An Examination. Many CPAs are comfortable with this practice when they have issued an unqualified examination report, which provides a high level of assurance. However, it’s important to make sure the client’s reference doesn’t imply that the assurance pertains to assertions not covered in the examination report.

A Review. When a company wants to circulate promotional material saying that assertions about its product have been “reviewed” by an independent CPA whose review report is available on request, some CPAs become uneasy. They believe many people are unaware that a review provides far less assurance than an examination. They’re concerned that a reader will infer a higher level of assurance than that actually provided. For this reason, they believe it’s inappropriate for a client merely to refer to the review report.

Nonfinancial Assertions. Similarly, some CPAs are concerned about how readers perceive the assurance provided by review engagements involving any nonfinancial assertions—even when

the review report is presented. To prevent any misunderstanding about the assurance provided on a nonfinancial assertion (such as attesting to software capabilities), some CPAs prefer to examine assertions or to perform agreed-upon procedures. In the latter case, attestation standards require that the report’s distribution be limited to the client and the users who have agreed on the engagement procedures.

In the agreed-upon-procedures engagement, the client and the users must understand that they take responsibility for the adequacy of the attest procedures—and therefore the amount of assurance provided—for their purposes.

NOT GAAP, NOT OCBOA

CPAs have asked if they can issue a general distribution examination report under attestation standards on financial statements that are neither in accordance with generally accepted accounting principles (GAAP) nor another comprehensive basis of accounting (OCBOA), but that spell out the basis of accounting in the notes. For example, a loan agreement may require the borrower to prepare financial statements where property, plant and equipment is presented at its current value.

When reporting on financial statements—or elements of financial statements—the auditor should refer to statements on auditing standards or statements on standards for accounting and review services for authoritative guidance—not attestation standards. The AICPA recently addressed this issue in the proposed statement on auditing standards on special reports. (See related article below). When financial statements follow neither GAAP nor another comprehensive basis, the auditor’s report should feature

- Restricted distribution of the report—for example, to those within the entity and the parties to the contract.
- An explanation of what the presentation is intended to show.
- A note that explains the basis of presentation and states that the presentation isn’t intended to conform with GAAP.

MONITORING THE STANDARDS

As CPAs provide new attest services, questions about how to apply the attestation standards will continue to arise. The AICPA’s auditing standards and management advisory services divisions monitor these questions and, when necessary, provides guidance to practitioners.

REPORTS ON OCBOA PRESENTATIONS: WHAT THEY ARE AND WHAT THEY AREN’T

by Mimi Blanco-Best

To report or not report conformity with GAAP? That is the question.

“Why should we?” wonder practitioners who believe that it is not necessary to include a statement that the financial statements aren’t GAAP in an auditor’s report on financial statements prepared in conformity with a comprehensive basis of accounting other than GAAP—commonly known as OCBOA. “If we tell financial statement users that the financial statements are prepared in conformity with an other comprehensive basis of accounting (like the tax or cash basis), why do we also have to tell them that the statements aren’t in conformity with GAAP?” they ask.

That’s the view of practitioners who oppose SAS No. 14’s (*Special Reports*) requirement that an auditor’s report on an OCBOA presentation include a statement that an OCBOA presentation isn’t GAAP. This controversy is not new, but it has heated up with the Auditing Standards Board’s issuance of an exposure draft titled “Special Reports.” This proposed SAS, which would supersede SAS No. 14, retains the requirement that an auditor’s report on OCBOA financial statements include a statement that the presentation is not

intended to be a presentation in conformity with GAAP. (It also requires a reference in the report to a note to the financial statements that describes—but does not necessarily quantify—how the presentation differs from a GAAP presentation, but we’ll discuss that later.)

This article contrasts the views of practitioners who oppose including a statement in the auditor’s special report that OCBOA financial statements aren’t GAAP with the views of those who favor such language and discusses how the Auditing Standards Board considered both views in drafting the recently-released exposure draft.

Why is GAAP So Special?

At the bottom of this controversy is the question “Why is it necessary to compare OCBOA financial statements with GAAP financial statements in the first place?” Critics of a reference to GAAP in the auditor’s special report on OCBOA financial statements contend that, for certain entities, financial statements prepared in conformity with an other comprehensive basis of

REPORTS ON OCBOA PRESENTATIONS: WHY THEY ARE AND WHAT THEY AREN'T (continued from page 2)

accounting are the best and most useful form of presentation. One reason for this belief is the higher cost associated with preparing GAAP financial statements. This concern, they maintain, results primarily from the growing number of complex accounting pronouncements that they say are not always cost-beneficial to apply in smaller, non-public entities.

Practitioners who favor a statement that the financial statements are not GAAP in the auditor's report on OCBOA statements argue that GAAP encompasses conventions, rules, and procedures that define accepted accounting practices at a particular time; therefore, it provides a standard against which all financial presentations should be measured. In contrast, there is no definitive, set criteria for other comprehensive bases of accounting that are acceptable to users and preparers alike, at least not to the same degree as GAAP is. Therefore, GAAP-based financial statements provide, to date, the best information in response to users' needs. And that's why it's important for users to understand that OCBOA financial statements aren't GAAP.

In addition, they contend, this rationale is also consistent with the first standard of reporting, which states that:

The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles.

In a report on OCBOA statements, the first standard is satisfied by the statement that the financial statements aren't GAAP.

Negative Language in Special Reports

CPAs who oppose the statement, in the auditor's report, that OCBOA financial statements aren't GAAP claim that it has a negative connotation to users of OCBOA financial statements. This language, they argue, makes an OCBOA presentation appear substandard (that is, somehow less credible than a GAAP presentation).

But proponents argue that users expect GAAP presentations. If users perceive that presentations that aren't in conformity with GAAP are not as useful, then accountants must deal with those perceptions. To omit language that explicitly states that the financial statements aren't GAAP, especially in light of these perceptions, might mislead financial statement users who are expecting—but not getting—GAAP financial statements.

What's the Answer?

The Auditing Standards Board has attempted to address some of these concerns in the exposure draft. The proposed SAS retains the requirement to state that the financial statements aren't GAAP but clarifies that it is not necessary to discuss how the presentation differs from a GAAP presentation in the report itself. Sample reports in SAS No. 14, like the following report on cash basis financial statements, include language that describes how the presentation differs from a GAAP presentation:

As described in Note X, the Company's policy is to prepare its financial statements on the basis of cash receipts and disbursements; *consequently, certain revenue and the related assets are recognized when earned, and certain expenses are recognized when paid rather than when the obligation is incurred.* Accordingly, the accompanying financial statements are not intended to present financial position and results of operations in conformity with generally accepted accounting principles.

Although the proposed SAS clarifies that it is not necessary to discuss how the presentation differs from GAAP in the auditor's report, it does retain the requirement to include such language in a note to the financial statements. (By the way, this difference still doesn't have to be quantified.) Furthermore, it proposes replacing the last sentence in the example above with a statement that the financial statements aren't intended to be a GAAP presentation. The Board believes that this language is much more straightforward and would increase user understanding by omitting terms normally associated only with GAAP financial statements (i.e., financial position and results of operations).

Critics argue, however, that the exposure draft doesn't go far enough toward removing the negative language. They would prefer to delete the requirement that the report state that the presentation is not GAAP and require such disclosure in the notes to the financial statements only. Some critics feel even more strongly—they advocate omitting note disclosure as well.

The exposure draft on special reports was released on August 31, 1988. The comment period ends on October 31, 1988. The Auditing Standards Board will consider comments in its subsequent deliberations on this guidance. So, the verdict is still out. . . .

TECHNICAL PLAN HIGHLIGHTS

PROJECTS RELATED TO IMPLEMENTATION OF NEW SASs

Special Reports (AICPA Staff: MIMI BLANCO-BEST). The Board issued an exposure draft of a proposed statement on auditing standards that revises SAS No. 14, *Special Reports*, to prescribe changes to special reports that reflect the new requirements of SAS No. 58, *Reports on Audited Financial Statements*, and to clarify requirements for issuing a special purpose report on special or incomplete presentations. (See "Recent Division Publications," page 4.) *Schedule*: The comment deadline is October 31, 1988.

Control Risk Audit Guide (RAY JOHNSON). The Board is developing an audit guide to assist auditors in implementing the new requirements of SAS No. 55, *Consideration of Internal Control Structure in a Financial Statement Audit*. *Schedule*: The Board plans to expose the proposed audit guide in 1989 prior to the effective date for SAS No. 55.

Updated Audit Reports (PATRICK MCNAMEE). The Auditing Standards Division is developing guidance that will update existing audit guides to reflect the new reporting requirements of SAS No. 58, *Reports on Audited Financial Statements*, and SAS No. 60, *Com-*

munication of Internal Control Structure Related Matters Noted in an Audit. *Schedule*: Guidance to be issued by fourth quarter, 1988.

Understanding Audits and the Auditor's Report, A Guide for Financial Statement Users (RAY JOHNSON). The Auditing Standards Division is updating its booklet that gives financial statement users a nontechnical explanation of the meaning of the revised auditor's standard report. In addition, a pamphlet on the auditor's standard report entitled "The New Auditor's Report: What It Means to You" is currently available through the order department of the AICPA. (See "Recent Division Publications," page 4.) Practitioners may find the information in the pamphlet useful when explaining the changes to the new auditor's report to clients and financial statement users. *Schedule*: Booklet to be published in the fourth quarter of 1988.

Communication With Audit Committees (or Others With Similar Responsibilities) (MIMI BLANCO-BEST). The Auditing Standards Division has prepared a pamphlet for distribution to audit committee members (or others with the responsibility for oversight of the financial reporting process) that discusses the auditor's responsibility to communicate certain information to them. (See "Recent Division Publications," page 4.)

TECHNICAL PLAN HIGHLIGHTS (continued from page 3)

Auditing Procedure Study: Audits of Small Businesses (RAY JOHNSON). The auditing procedure study *Audits of Small Businesses* is being revised to reflect the new SASs (52-61). The chapters on evaluating internal controls and on analytical review will be revised to discuss the implementation of SAS Nos. 55 and 56, *Consideration of the Internal Control Structure in a Financial Statement Audit*, and, *Analytical Procedures*, in the small business audit. Other changes will be made throughout the study to provide guidance that is consistent with the new standards. *Schedule*: The revised auditing procedure study will be available by mid-1989.

OTHER PROJECTS OF THE AUDITING STANDARDS DIVISION

Reporting on Pro Forma Financial Information (JANE MANCINO). An attestation standard was published in September 1988. This standard provides guidance to an accountant who is engaged to examine or review pro forma financial information. (See "Recent Division Publications," below.)

Compliance Auditing (PATRICK MCNAMEE). The Board has issued an exposure draft of a proposed SAS on compliance auditing. This proposed statement would provide guidance on the auditor's responsibility in an engagement to report on compliance with laws and regulatory requirements of government financial assistance programs. Comment deadline was August 15, 1988. *Schedule*: The Board will discuss revisions to the exposure draft at its October 1988 meeting.

Codification Framework (JANE MANCINO). The Board is discussing a revision to the framework of the *Codification of Statements on Auditing Standards* that will make the *Codification* more relevant and useful to practitioners and that will permit the effective integration of future auditing standards. *Schedule*: An issues paper will be discussed at the October 1988 Board meeting.

Reporting on Internal Control (PEG FAGAN). The Board is considering alternative models for general distribution reporting on an entity's internal control structure, determining the circumstances in which each of those models is appropriate for such reporting, and developing performance and reporting guidance under each of the appropriate models. *Schedule*: At its October meeting, the Board will discuss issues related to providing limited assurance about an entity's internal control structure.

Reliance on Internal Audit (MIMI BLANCO-BEST). The Board is considering revising SAS No. 9, *The Effect of an Internal Audit Function on the Scope of the Independent Auditor's Examination*, to reflect the audit risk model, the new standards, and current practice. *Schedule*: The Board will discuss a draft of a proposed SAS at its October meeting.

Internal Auditor Procedure Study (ALAN WINTERS). The Auditing Standards Division, in conjunction with the Canadian Institute of Chartered Accountants, is preparing an auditing procedure study on the use of internal auditors. *Schedule*: This procedure study will be published in the fourth quarter 1988.

Use of Confirmations (PEG FAGAN). The Board created a task force to develop guidance on the use of confirmation procedures in audit engagements. The Board deferred issuance of the revised standard bank confirmation form until the task force develops a notification to practitioners that outlines the revisions and discusses why those revisions were made. *Schedule*: The Board will discuss this project at its October meeting.

Financial Forecast and Projections (MIMI BLANCO-BEST). The Board created the Forecasts and Projections Task Force to deal with problems encountered in implementing the guidance in the Statement on Standards for Accountant's Services on Prospective Financial Information. An exposure draft of a proposed Statement of Position titled *Questions Concerning Accountant's Services on Prospective Financial Information* was issued in September. (See "Recent Division Publications," below.) The Task Force is also working on a proposed Statement of Position that will provide guidance to practitioners on reporting on partial presentations of prospective financial information and prospective financial statements for internal use only. *Schedule*: Comment period on exposure draft expires November 2, 1988.

Computer Auditing (MARK BEASLEY). The Computer Audit Subcommittee and related task forces are responsible for developing guidance for auditors about the effects computers have on the audit process and advising the Board and other senior technical committees and the membership on computer-related matters. The Subcommittee currently is drafting guidance in the form of auditing procedure studies that consider the implementation of SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*, in a small, non-complex computer environment and in a large, complex computer environment. *Schedule*: Proposed drafts of the procedure studies will be discussed at the Subcommittee's October 1988 meeting.

RECENT DIVISION PUBLICATIONS

The Division has published two informational brochures designed to help auditors communicate with their clients and others interested in auditors' work. "The New Auditor's Report: What It Means to You" explains changes brought about by SAS No. 58, *Reports on Audited Financial Statements*. "Communication with Audit Committees" is written to explain to audit committees about the auditor's responsibilities under the recently issued SAS No. 61, *Communication with Audit Committees*. These publications (product numbers 022014 and 022029, respectively) can be obtained by writing the AICPA's order department at 1211 Avenue of the Americas, New York, NY 10036.

In September 1988, the Division published a Statement on Standards for Attestation Engagements, *Reporting on Pro Forma Financial Information* (product number 023055). The Division has also published two exposure drafts: a proposed Statement of Position "Questions Concerning Accountants' Services on Prospective Financial Statements" (G00274), and a proposed Statement on Auditing Standards "Special Reports" (G00475).

These publications can be also obtained from the AICPA's order department.

In Our Opinion is published quarterly by
Auditing Standards Division
American Institute of CPAs
1211 Avenue of the Americas
New York, NY 10036-8775

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